

**CALIFORNIA PUBLIC EMPLOYEES' RETIREMENT SYSTEM  
STATEMENT OF INVESTMENT POLICY**

**FOR  
OPPORTUNISTIC REAL ESTATE**

**February 14, 2006**

*This Policy is effective immediately upon adoption and supersedes all previous opportunistic real estate policies.*

**I. PURPOSE**

This document sets forth the investment policy ("the Policy") for the Opportunistic Real Estate Portfolio ("the Portfolio") which is governed by the Statement of Investment Policy for Equity Real Estate. The design of this Policy ensures that investors, managers, partners, consultants, or other participants selected by the California Public Employees' Retirement System ("the System") take prudent and careful action while managing the Portfolio. Additionally, use of this Policy provides assurance that there is sufficient flexibility in controlling investment risks and returns associated with the Portfolio.

**II. STRATEGIC OBJECTIVE**

From time to time, mis-pricing of Real Estate assets and/or intentionally taking on higher risk provides investors with the potential for earning superior risk-adjusted rates of return. Generating superior returns with acceptable risk levels compared to the System's Direct Core Equity Real Estate Portfolio is the overriding objective of the Program. This objective shall consider prudent levels of risk, the liabilities of the System, and the investment guidelines contained herein. The investment selection shall be oriented to achieve the objectives of enhanced returns to the total portfolio, preservation of capital and diversification of risk. "Opportunistic" real estate investments encompass a wide range of investment strategies, investment structures and geographies.

Although Opportunistic investments may be international in location, generally they differ from international real estate investments in their target risk adjusted returns, property or investment vehicle type and timing for execution of niche strategies. Additionally, on a portfolio basis, Opportunistic investments are generally more tactical in nature versus strategic.

The System shall make such investments under specified conditions and circumstances as described in this statement. The System's ability to commit and efficiently deploy large amounts of capital provides the System a distinct advantage when investing in opportunistic real estate investments.

The expected rates of return shall be commensurate with the incremental risk undertaken in the investment program. Opportunistic investments shall provide superior returns with acceptable risk levels when compared to direct equity U.S. real estate investments. Additionally, rates of return will reflect the unique strategies associated with the investment opportunities that shall include, but are not limited to, such factors as relative stages of development and or redevelopment, targeted property types, entity or debt vehicles, relative control or liquidity or both that are associated with the investment, and other structuring techniques used to mitigate taxes, and currency exposure, if any.

The Opportunistic Real Estate Portfolio shall be managed to accomplish the following:

- A. Generate attractive risk-adjusted rates of return for the System;
- B. Provide diversification;
- C. Preserve investment capital;
- D. Provide a hedge against inflation;
- E. Provide appreciation potential;
- F. When sufficient investment opportunities are available, achieve tactical goals for the overall Equity Real Estate Portfolio; and
- G. Consider solely the interests of the System's participants and beneficiaries in accordance with California State Law.

### **III. PERFORMANCE OBJECTIVES**

- A. Exceed (after fees), leveraged, on a portfolio basis, a minimum target nominal rate of return of approximately 13%. The Senior Investment Officer may approve funds below this target or require a higher target depending on the characteristics of the individual fund or changes in the market place (i.e., inflation, capital markets or risk levels of available investment opportunities, etc.). Expected returns, on each new fund committed, will be reported to the Investment Committee shortly after fund closing and;

- B. When appropriate, customized benchmarks shall also be developed for these investments, taking into account specific risk attributes of the investments. At a minimum, investments in Opportunistic Real Estate shall maintain an appropriate level of diversification to mitigate risk.

#### **IV. ASSET ALLOCATION**

The Opportunistic Real Estate allocation is set forth in the Statement of Investment Policy for Equity Real Estate. The current asset allocation range for the Portfolio, as a percentage of the total real estate equity allocation, is based on market values.

From time to time, the actual allocations may fall out of the ranges prescribed by Policy. In these instances, the System shall implement adjustments to correct the actual allocations to comply with the Policy allocation ranges within a reasonable time frame. Implementation that occurs within a three-year period, with ample consideration given to preserving the System's investment returns, is considered a reasonable time frame.

#### **V. INVESTMENT APPROACHES AND PARAMETERS**

##### **A. Risks**

The following factors shall be considered in assessing the attractiveness of opportunistic real estate investing:

1. Current market conditions in the U.S., whether the proposed investment opportunity offers the requisite premium return relative to the U.S. market overall.
2. The difficulty in obtaining information regarding the behavior of private real estate markets in the U.S. and globally as well as benchmarking performance;
3. When applicable by Strategy, significant variance in risk and return attributes of real estate in the U.S. and developed countries compared with those associated with markets in developing countries;
4. The use of leverage to maximize return and/or minimize the tax burden often associated with opportunistic real estate investments and the direct impact this leverage has on the risk and required return of such investments;

5. Leverage utilized in opportunistic strategies can be aggressive and thereby add incremental risk; and
6. Opportunistic strategies may also encompass a deferral of current income for an incrementally greater total return.

The mitigation of risks shall be achieved through techniques such as, but not limited to, the following:

1. Prudent underwriting;
2. Appropriate legal and tax review;
3. Meaningful alignment of interest by General Partner and or Fund Sponsor; and
4. Retention of qualified experts familiar with the markets or investment type under consideration, as necessary.

**B. Diversification Guidelines**

The Portfolio shall reduce risk through appropriate diversification. Diversification shall occur primarily by geography and investment strategy, as outlined below.

**1. Diversification by Geography**

Given the specialized nature of opportunistic equity or debt secured real estate investments, and the stated overall objective, it is not possible to mandate strict geographic diversification guidelines for these investments. Capital allocations shall be primarily driven by market opportunities. The System shall seek to maintain a prudent level of diversification within and among such investments.

**2. Diversification by Strategy**

The System shall employ a broad range of strategies for Opportunistic real estate investments. The allocation ranges established for each of the recommended strategies are a percentage of the Total Real Estate Portfolio listed below. To mitigate risk, the System shall place less emphasis on strategies carrying a greater degree of uncertainty.

When investing in opportunistic real estate, prudent review and due diligence shall include review of political, economic, and social risks,

as well as expropriation probabilities associated with the respective countries. In instances such as commingled funds where the System may not have control over the investments, Staff will closely monitor such funds and report to the Investment Committee when such investments are at risk.

Care shall be given to avoid undue concentrations in developed or developing countries, or in any one particular country, region, property type or strategy.

In those instances where investments are being considered in Emerging Markets, the Senior Investment Officer, (SIO), Real Estate shall have the discretion to permit real estate investments in emerging countries that obtain a favorable score, as approved by the Investment Committee, on the Wilshire Permissible Equity Market List with the exception of the capital market factors, as updated and reviewed annually. Emerging countries that do not score favorably on the Wilshire Permissible Equity Market List, but demonstrate compelling investment rationale will require Investment Committee approval. Emerging countries that are not reviewed in conjunction with the Wilshire Consulting Permissible Equity Market List, and are deemed to have sufficient investment merits, will require Investment Committee approval. Recognizing the ability of emerging countries to fall on and off the Permissible Equity Market List, investments will be approved for real estate investment according to the list in effect at the time of the proposed investment.

The Senior Investment Officer of Real Estate may allow a specific Opportunistic real estate sector to exceed 10% [Speculative Development](#) as long as the **overall** Total Real Estate Portfolio Speculative Development Level **does not** exceed 10%.

From time to time, the actual allocations of various geographic sectors and investment strategies may fall out of the ranges prescribed by the Policy. In these instances, the System shall implement adjustments correcting the actual allocations so they comply with the Policy allocation ranges within a reasonable time frame. Implementation that occurs within a three-year period, with ample consideration given to preserving the investment returns for the System, is considered a reasonable time frame. Any material exceptions to policy shall also be disclosed in the Real Estate Quarterly Performance Report as presented to the Investment Committee quarterly.

**C. Investment Size**

The size of opportunistic real estate investments shall depend on the investments and strategies available to the System, with neither small nor large investments dominating the Portfolio. Additionally, investment size shall be appropriate to the projected risk/return level of the investments. However, in order to have some composite effect on the Portfolio, preference shall be given to investments with funding commitments of \$50 million or greater in size.

**D. Structures**

The Program shall be implemented through direct real estate equity investments (either through separate accounts or through commingled vehicles), or through private or publicly traded real estate securities, or some combination thereof. Equity, leveraged equity, mezzanine debt and hybrid investment are examples of some of the structures for direct investment in opportunistic real estate by the System.

**E. Vehicles**

The System shall consider a number of investment vehicles for investing opportunistically in real estate, or real estate related investment vehicles, including, but not limited to, the following:

1. Direct real estate equity investments in 100% owned assets;
2. Real estate equity joint ventures or other co-investment vehicles for real estate;
3. Indirect private or public real estate equity investments in commingled funds, private or publicly traded Real Estate Investment Trusts (REITs), limited partnerships, or other pooled investment vehicles;
4. Purchase of controlling or non-controlling interests of public or private real estate operating companies; and
5. Debt structures (subordinate, mezzanine, preferred, participating, performing or distressed debt) throughout the capital structure.

In choosing specific investment vehicles for opportunistic real estate, the System shall consider, but not limit its options to, the following:

1. Proposed investment strategy;
2. Expected risk and return attributes of vehicles;
3. Potential exit strategies and liquidity;
4. Appropriate levels of control;
5. Monitoring costs and feasibility;
6. Potential diversification benefits;
7. Tax considerations;
8. Other incremental costs;
9. Governance and control of structure; and
10. Partners or co-investors.

#### **F. Selection of Investment Management Firms**

The System shall invest in opportunistic real estate investments on a direct or indirect basis through third-party investment advisors, general partners, operating company management teams, or other organizations with specific expertise in opportunistic real estate investments (collectively referred to as "Management Firms"). Management Firms selected under the opportunistic program will provide CalPERS with access to a larger pool of specialists with unique expertise in market segments not widely available to CalPERS in the general Real Estate program.

Management Firms shall provide expertise and experience locating, negotiating the acquisition, monitoring, and disposing of opportunistic real estate equity or debt investments. Before selection, the System shall establish and document specific relevant criteria for each Management Firm to establish the basis upon which to make the selection.

Selection of management is critical to the success of the Opportunistic Real Estate Program. The System shall approve Management Firms based on their specific, successful and significant expertise (including the ability to mitigate risks identified

in these markets) in locating, negotiating the acquisition, monitoring, and disposing of opportunistic real estate investments, in the particular, specific real estate markets. Management Firms shall act in a fiduciary capacity and represent only the interests of the System in these transactions or, if the System is a co-investor, only the interests of the investor or shareowner group.

#### **G. Asset Management**

Management Firms shall represent the System's interests in asset management decisions, providing daily property management services, as expertise and organizational structure allow. The System shall give Management Firms appropriate Delegation of Authority while requiring that they provide adequate measures of accountability.

Appropriate financial and operational controls, as well as reporting requirements applied to direct domestic equity real estate investment, shall also apply to direct opportunistic real estate investment, to the extent consistent with the investment practices of local jurisdictions where appropriate. This shall include audited financial statements on a basis consistent with the System's accounting policy where appropriate. U.S.-dollar denominated accounting and performance information shall be required.

### **VI. GENERAL**

Unless otherwise noted, investors, managers, consultants, partners, members or other participants selected by the System shall base all calculations and computations on Fair Market Value, as defined by the Uniform Standards of Professional Appraisal Practice (USPAP) of the Appraisal Foundation for accounting purposes. See Statement of Investment Policy for Equity Real Estate Appraisal and Valuation.

### **VII. GLOSSARY OF TERMS**

Definitions for key words used in this policy are located in the Real Estate Glossary of Terms which is included in the System's Master Glossary of Terms.

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